

OFFICIAL FILE
ILLINOIS COMMERCE COMMISSION STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ORIGINAL
RECEIVED
APR 6 2001

In the Matter of)	ILLINOIS COMMERCE COMMISSION
)	CHIEF CLERK'S OFFICE
Illinois Bell Telephone Company)	98-0252
)	
Application for Review of Alternative)	
Regulation Plan)	
)	
Illinois Bell Telephone Company)	98-0335
)	
Petition to rebalance Illinois Bell Telephone)	
Company's Carrier Access and Network)	
Access Line Rates)	
)	
Citizens Utility Board and)	00-0764
The People of the State of Illinois)	
-vs-)	
Illinois Bell Telephone Company)	
)	
Verified Complaint for a Reduction in Illinois))	
Bell Telephone Company's Rates and Other))	
Relief)	(consolidated)

REPLY BRIEF OF THE STAFF
OF THE ILLINOIS COMMERCE COMMISSION

April 6, 2001

Matthew L. Harvey
David L. Nixon
Sean R. Brady
Illinois Commerce Commission
Office of General Counsel
160 North LaSalle Street
Suite C 800
Chicago, Illinois 60601

T: 312/ 793.2877
F: 312/ 793.1556

TABLE OF CONTENTS

I. OVERALL SUMMARY OF THE CASE	1
II. REVIEW OF THE ALTERNATIVE REGULATION PLAN.....	6
A. Scope of the Review Proceeding.....	6
B. Commission Goals for the Plan	6
C. Earnings	6
D. Docket No. 98-0860 and the Instant Proceeding.....	10
E. Ameritech's Application of the Plan	10
3. Problems with the Structure of the Service Baskets.....	10
a. Local Call Plans Should be Placed in Residence Basket	10
b. Exclusion of Services from Price Cap Plan.....	13
c. Reclassified Services	13
III. STAFF'S GOING FORWARD PROPOSAL	15
A. Proposal Relative to Existing Components.....	15
1. The Price Cap Formula.....	15
a. Inflation Factor	15
b. "X" Factor	15
c. "Z" Factor	18
d. "Q" Factor.....	20
2. Ameritech's Proposed Pricing Flexibility	21
a. Pricing Flexibility and Competition	21
b. Pricing Flexibility and Basket Structure	22
B. New Components	25
C. Re-initialization of Rates	25
D. Earnings Sharing	28
E. Rate of Return	29
F. Reporting Requirements	30
G. Merger Costs and Savings	31
IV. SERVICE QUALITY	36
A. The Legal Standards	36
B. History of Service Quality in the Current Alternative Regulation Plan.....	41
1. Ameritech Illinois' Reported Service Quality Performance	41
2. Installation Definition	43
3. Wholesale Performance Measure Recommendation	46
C. Proposed Incentive Structures.....	47
1. Consumer Compensation Outside of the Plan	48
2. Measures Remaining Inside the Plan	56
3. Service Quality Penalties In The Plan.....	61
V. REVENUE REQUIREMENT ANALYSIS.....	64
A. Revenue & Expense Adjustments	64
1. Interest Synchronization	64

2. Pension Settlement Gains	65
3. Directory Revenue	67
4. Incentive Compensation Expense	69
5. Social and Service Club Dues	70
6. External Relations Expense.....	71
7. FAS 71 Adjustment	71
8. Depreciation and Amortization	75
a. Depreciation and Amortization Expense	75
b. Depreciation and Deferred Tax Reserves.....	77
B. Rate Base Adjustments	77
1. Telephone Plant Under Construction	77
C. Cost of Capital	78
1. Capital Structure – Reply to Ameritech	78
2. Return on Common Equity	80
a. Reply to Ameritech.....	80
b. Reply to the Attorney General.....	81
c. Rate Re-initialization	81
VI. COST OF SERVICE	83
A. LRSIC Cost of Capital.....	83
B. Ameritech LRSIC Studies	83
VII. RATE DESIGN	85
A. Rate Rebalancing	85
B. Reciprocal Compensation.....	89
C. Rate Re-initialization	90
VIII. CUB/AG COMPLAINT	91
IX. CONCLUSION	91

The Staff of the Illinois Commerce Commission ("the Staff"), by and through its counsel, and pursuant to Section 200.800 of the Commission's Rules of Practice (83 Ill. Adm. Code 200.800), respectfully submits its Reply Brief in the above-captioned matter.

I. OVERALL SUMMARY OF THE CASE

This case is a review of the performance of the alternative regulation plan (hereafter referred to as the "Plan") that the Commission adopted, and Illinois Bell Telephone (hereafter referred to as "Ameritech Illinois", "Ameritech" or the "Company") has been operating under since 1994. The review of the Plan is to determine whether, and to what degree, it has met the statutory and regulatory goals set for it.

See Staff IB 5-11 (setting forth the scope of review pursuant to sect. 13-506.1)

Staff's Reply brief will summarize the position of the parties and intervenors that submitted initial briefs and address their arguments. Essentially the parties can be cast into four groups: first there is Ameritech -- advocating de minimis changes to the current plan; second is Staff -- advocating improvements in the price cap index and service quality, and as an alternative, rate reinitialization, but against rate of return; third, are Government and Consumer Intervenors ("GCI") comprised of the Attorney General of the State of Illinois, State's Attorney for Cook County, City of Chicago and Citizen's Utility Board ("CUB") -- advocating significant changes to the price cap index and service quality, and in the alternative, a rate-of-return; fourth, and Department of Defense and All Other Federal Executive Agencies ("DOD/FEA"), McLeodUSA Telecommunication USA (McLeod"), and AT&T Communications Inc. of Illinois -- focusing on discrete issues, but not the entire case.

Staff's Position

In Staff's opinion, the Plan has functioned reasonably well with certain exceptions. In addition, Staff finds no persuasive evidence indicating that the rates produced under the Plan for non-competitive services are not just and reasonable.

Staff has identified several defects over the life of the Plan. First, and most significant, there has been a marked decline in service quality, as measured by indices designated in the Plan. Second, Ameritech has structured its annual price cap filings to reduce consumer benefits under the Plan¹. Third, Ameritech prematurely reclassified non-competitive services as competitive, thereby allowing them to raise rates without fear that competitors are offering lower rates. Staff IB at 46. In sum, these three defects have significantly reduced the benefits to the consumer while Ameritech received healthy returns.

To redress the defects in the plan and bring it back into compliance with the statutory and regulatory goals set for it, Staff recommends that the current Plan be extended, and that rates should not be reinitialized, nor should Ameritech revert to a rate-of-return regulation. In modifying the current Plan, Staff recommends a "one-time" reduction in revenue, a modification the current price cap index ("PCI"), the retention of the four carrier baskets of services, and the denial of rate rebalancing. Staff recommends the "one-time" reduction of revenues to be no less than \$36.9 million. The PCI should have a productivity factor ("X-factor") of 4.3%, the exogenous change factor ("Z factor") should be modified, and the service quality factor ("Q factor") should be removed from the PCI. In replacement of the Q factor, Staff recommends that

Ameritech directly compensate customers. Finally, the Commission should deny the complaint filed by the Attorney General of Illinois and the CUB. Staff's modifications to the Plan will correct the problems in the Plan and establish just and reasonable rates.

Ameritech's Position

Ameritech suggests that the Plan has worked well over the past seven years, noting benefits and protections customers have received, while at the same time, Ameritech was able to improve productivity, streamline operations, and invest in its network infrastructure without increasing noncompetitive service rates. Ameritech IB at 3. Accordingly, Ameritech proposes de minimis changes to the price cap index, increased pricing flexibility by consolidating the four current carrier baskets into one, and only a few changes to the service quality component of the Plan. In terms of rebalancing rates, Ameritech seeks to increase its residential network access line rates, because they do not cover their fair contribution to recovery of Ameritech's shared and common costs. Ameritech IB at 11.

GCI's Position

The parties comprising GCI generally advocate the same positions concerning the PCI and service quality, with minor variations. Their overall perspective on the Plan is that it has failed, or performed poorly, in accomplishing the goals of Section 13-506.1 in the last five to seven years. Specifically, GCI notes that service quality has deteriorated while Ameritech has received a return on equity far in excess of what was set in the Plan. GCI therefore recommends that significant changes should be made to the price cap index and the service quality standards and service quality incentives to

¹ Staff is of the opinion that Ameritech's annual filings have generally overstated consumer benefits, and the rates it has elected to reduce have been those for which rate reductions would lead the increased

accomplish the goals and intent of Section 13-506.1. If these changes cannot be made, GCI recommends that the Commission rescind Ameritech's current alternative regulation plan and reinstate rate-of-return regulation.

GCI's proposal specifically includes increasing the X factor from the current 4.3% to 6.5%. In terms of service quality, GCI proposes to substantially expand the number of service quality measures, and significantly increase the magnitude (dollar amount) of the service quality financial incentives.

DOD/FEA's Position

DOD/FEA finds that Ameritech's rate rebalancing proposal to increase monthly charges by \$2.00 is reasonable because it will allow the Company to better align its rates with its costs. However, DOD/FEA suggests that lifeline-qualified consumers be exempt from this increase. Ameritech proposes a large revenue reduction in carrier access charges. DOD/FEA is concerned that interexchange carriers are not going to flow through these savings to the customer. To resolve this problem DOD/FEA makes two proposals: an interexchange carrier must (i) demonstrate full flow-through, and (ii) reduce all monthly network access line charges by amounts that are equal to the reductions in access charges not passed through to the ratepayers. If the Commission proposes substantial overall revenue reduction DOD/FEA recommends reductions in business line charges to close the gap between residential and business rates, greater reductions in calls originating on business lines, equalizing the charges for business and residence users unless there are differences in the costs in providing the service, and a reduction in intrastate switched access charges of approximately \$43.8 million.

demand.

AT&T's Position

AT&T's comments were conditioned on the proposition that the Commission will affirm an alternative form of regulation. AT&T argues that (i) carrier access services (switched and nonswitched) should continue in the price cap index; (ii) UNE's, interconnection, and transport and termination services should be included in the carrier basket, and (iii) the non-negotiated rates for these services are subject to individual price caps based on the most recent non-negotiated TELRIC rates approved by the Commission, and should be updated annually by the change in PCI. In addition, AT&T states that wholesale services should be included in the price cap index, and placed in the Retail Service Basket. Upon reviewing service quality, AT&T found the performance measurements and remedy plan in the current Alt. Reg. Plan appropriate. Finally, AT&T advocates a \$10 million reduction of access revenues if the Commission allows Ameritech to rebalance its rates.

McLeodUSA's Position

McLeod's brief focuses only on service quality. McLeod advocates that whatever service quality measures are implemented should conform to the idea of "parity with a floor." Further, McLeod argues that the same service quality measures should apply equally to Ameritech's retail customers and to its wholesale customers. The level of service must be a level that represents adequate service – a "floor."

The Staff notes that the Hearing Examiners have directed the parties to use a specific outline and format for their Briefs in this proceeding. The Staff uses this outline for this Reply Brief. However, in the Staff's view, certain sub-topics need not be addressed in this Reply. As a result, there are several points in this Reply Brief where

Staff has not presented argument on a specific topic, despite the fact that the topic is in the Hearing Examiners' outline. In such circumstances, it should be assumed that Staff's arguments as set forth in its Initial Brief are incorporated herein as if fully realleged.

II. REVIEW OF THE ALTERNATIVE REGULATION PLAN

A. Scope of the Review Proceeding

Staff provided a detailed review of the Scope of this proceeding in its Initial Brief at 5-11.

B. Commission Goals for the Plan

Staff provided a detailed review of the Commissions Goals for the Plan in its Initial Brief at 12.

C. Earnings

Staff's Initial Brief sets forth Staff's recommendation that there should be no adjustment to Ameritech's aggregate revenues in this proceeding due to Ameritech's earnings levels over the life of the plan. Staff IB at 4. The Initial Brief also reiterates Staff's belief that Ameritech's aggregate revenues should be reduced as part of the resolution of issues in Docket No. 98-0860. Staff IB at 3. The March 30, 2001 HEPO in Docket No. 98-0860, if adopted by the Commission, would reduce Ameritech's "ongoing" revenues in the range of \$100 million annually. Staff estimates that adoption

of this HEPO also would result in one-time refunds to end users in the range of \$150 to \$200 million.

GCI's recommendation that rates be reinitialized in this proceeding based on Ameritech's earnings, see, e.g., City IB at 37; AG IB at 31 *et seq.*, should be rejected. The arguments advanced in support of reinitialization are unconvincing, precisely because they do not focus on Ameritech's rates, but rather upon Ameritech's rate of return, see, e.g., AG IB at 31 *et seq.*; CUB IB at 37, or matters extraneous to the Plan itself, such as reclassification. Id. Such arguments betray a failure to understand, or accept, the purpose of performance-based regulation, which focuses primarily on the regulated company's price performance, rather than on its earnings. In essence, GCI simply refuses to grapple with this principle.

The Commission should not assume, however, that Staff is in complete, or even substantial, agreement with Ameritech regarding certain aspects of rate reinitialization. Staff wishes to clarify several important differences between its positions on these issues and those presented in Ameritech's Initial Brief.

Ameritech contends that the incentive mechanisms that underlie the fundamental superiority of alternative regulation vis-à-vis rate of return ("ROR") derive from, and depend on, an absolute absence of a ceiling on earnings under alternative regulation. Ameritech IB at 21. According to Ameritech, under alternative regulation, the sky is the limit on earnings. The Commission should reject this position.

Rates produced by an alternative regulation plan must be just and reasonable. 220 ILCS 5/13-506.1(a)(6); (b)(2); (e). Staff demonstrated that the proper standard to be applied under alternative regulation is not the imposition of rate levels associated

with rate of return regulation, but rather an evaluation of whether the Plan produces affordable, just, and reasonable rates – a price performance analysis. Staff IB at 47. Ameritech, however, is incorrect in contending that earnings analyses have no place in an alternative regulation environment, i.e., that any level of earnings produced by a plan are acceptable, and that any rates produced by a plan are, by definition, just and reasonable.

The statutory fair, just and reasonable rate standard, of course, places upper and lower limits on acceptable rate levels under an alternative regulation plan, and earnings levels associated with those rates. For a variety of reasons, the “zone of reasonableness” of rates is broader and more elastic under alternative regulation than under rate of return regulation.² However, the zone of just and reasonable rates under alternative regulation is not unlimited.³

It is bounded on the lower end by considerations of financial integrity of the regulated company, and its attendant ability to deliver appropriate levels of service availability and quality. To illustrate, suppose Ameritech’s financial condition had deteriorated during the Plan to a degree that threatened its ability to provide adequate service to consumers. There can be no doubt the Commission’s statutory responsibilities would have required it to intercede by adjusting prices and/or key plan parameters to forestall or ameliorate significant adverse consequences.

² This is inherently part of the alternative regulation “compact”. It reflects such realities as increased competitive entry, generally increased risk for the regulated firm, and the potential for increased benefits for all stakeholders, notably consumers.

³ Staff does not believe that Ameritech seriously would propose that either negative earnings levels or levels in excess of, for example, 200% over the plan to date should not trigger, under any circumstances, revenue adjustments during this review.

The zone of reasonableness also is bounded on the upper end by earnings levels that clearly exceed those that could be explained by enhanced cost effectiveness, and technical and market progressiveness of the regulated company. Beyond this bound are earnings levels associated, at least in part, with such things as significant misspecification of Plan parameters, misapplication of the Plan, or behavior that successfully defeats the overall effectiveness of an alternative regulation plan.

These bounds and the fair, just and reasonable standard under alternative regulation are not readily susceptible to prior or precise quantification; their application thus requires informed regulatory judgement and analyses. This does not, however, diminish the importance of these bounds, or call into question their existence. Since prices alone do not provide directly the required information, earnings appropriately and necessarily are used as a proxy indicator. This is the major role of earnings analyses in any review of an alternative regulation plan. Staff concluded in this proceeding that Ameritech's rates and related earnings are not outside the zone of reasonableness, either on the low or high side, and has pointed out the lack of persuasive evidence to the contrary in its Initial Brief. Staff IB at 2. It must be recognized, however, that prices and associated earnings outside this zone could have occurred, and there was no assurance in 1994 against such a result. Similarly, it is conceivable that this could occur in the future under an extension of the alternative regulation plan, despite the expectations or intentions of the Commission, Ameritech or other parties. Thus, any extension of the plan should provide for a review comparable to this proceeding, preferably to be concluded no later than five years from the date of extension of

alternative regulation. Analysis of Ameritech's earnings, as well as its price performance, should be - and must be - an integral component of that review.

D. Docket No. 98-0860 and the Instant Proceeding

In its Initial Brief at 14, Staff provided a detailed review of the impacts that the decision in Docket 98-0860 could have on this docket. A Hearing Examiners' Proposed Order was issued in that Docket on March 30, 2001. This would seem to indicate that the Commission will reach a final decision on the reclassification issues before this case has ended. Staff believes that the Commission should consider the impact of its reclassification determinations on the issues in this proceeding.

E. Ameritech's Application of the Plan

3. Problems with the Structure of the Service Baskets

a. Local Call Plans Should be Placed in Residence Basket

Ameritech uses FCC price cap definitions to argue that a restructured service should be considered a new service. Ameritech IB at 45-46. Although FCC rulings concerning new services in price cap plans may prove useful by our Commission in developing its own rules, the Plan as adopted for AI in Illinois does not depend on these rules. Ameritech does not give any reason in witness testimony or in its Initial Brief as to why the Commission should rely on FCC decisions in this regard. Further, using the FCC rules as quoted by Ameritech on page 46 of its initial brief, optional Centrex and ValueLink services introduced by Ameritech would necessarily need to be considered new services. As these are new services, Ameritech would have to follow the same

criteria as existing services for competitive declaration. However, Ameritech has introduced several options for Centrex and ValueLink under its competitive tariff without applying these criteria. Staff Ex. 27 at 16. Neither Staff nor Ameritech address competitive classification criteria in evaluating filings relating to Centrex and ValueLink, because they are existing competitive services which have been repackaged, and not new services in themselves. Ameritech cannot have it both ways; either it has unlawfully avoided the proper classification process for Centrex and ValueLink, or its residential calling plans are not new services. Ameritech cannot apply this logic subjectively, when it suits its needs.

Ameritech asserts that there are significant administrative problems with introducing new services into the Plan that applying the FCC approach would avoid. Al Exhibit No. 1.3 at 91-92; Ameritech IB at 46. Specifically, Ameritech states that calling plans need to be treated as new services because the historic demand needed to calculate the API does not yet exist. Id. This argument, however, is a red herring. There is no impact on the API even if calling plans are excluded from the plan for one year or if no historic demand figures are available.

Ameritech asserts that the Commission's objective in placing some residential services in the Other Services Basket was to partition discretionary services from basic services. Id. Ameritech, however, does not cite any place in the Alt. Reg. Order where the Commission states this "objective." Therefore, this appears to be nothing more than Ameritech's self-interested assessment of what the Commission's objective was in the Alt. Reg. Order. Regardless of what the Commission's objective was in partitioning residential services from others, Ameritech's characterization of calling plans as

discretionary is unsupported. Usage services, of which these calling plans are a subset, are basic services in all cases. Just because customers may choose a calling plan to obtain these basic services does not change the fact that usage is a basic service. If customers choosing a calling plan always receive lower rates than under the standard rate structure, then arguably no protection against discrimination is needed for these customers. However, this is not always the case. The Commission specifically found in Docket No. 00-0043, that Ameritech made misleading representations to consumers regarding whether they could expect to save money under one of Ameritech's calling plans. Accordingly, protection is still needed.

Viewing calling plans as discretionary has significant negative impacts on consumers. First, if calling plans are discretionary, then standard calling rates must also be discretionary. Therefore, it follows that all residence usage services should be placed in the Other Services Basket. Following such logic would result in the loss of all protection against discrimination for basic residential services. Second, allowing calling plans to be introduced in the Other Services Basket has, in fact, been harmful to consumers. Continuing to keep calling plans in the Other Services Basket, or granting Ameritech's proposal to combine all services into one basket, would only increase the harm to consumers.

Ameritech claims that the issue of placing calling plans in the appropriate service basket would go away in their proposal to combine baskets. Id. This point is marginally valid, precisely because such a proposal would eliminate all protections residential ratepayers have against discrimination. Staff's concerns regarding discrimination are

even more salient in the event of basket combinations, as is discussed in Section III. A.2 of this Reply Brief.

b. Exclusion of Services from Price Cap Plan

Ameritech recommends that wholesale services and carrier access charges be removed from the Plan. It argues that the Commission established rates for services wholesale in ICC Docket No. 95-0458/0531 (Consolidated) and that there is nothing in TA96 to contemplate further reductions to these rates. Ameritech IB at 47. Staff is of the opinion that the formula from which wholesale rates are set represents a price ceiling, though, and that rate reductions are possible for wholesale services. Tr. 579, 587. As such, Staff sees no reason to exclude these noncompetitive services from the Plan.

Ameritech argues that carrier access charges no longer need to be part of the Plan due to the Order in 97-0601/0602 (Consolidated) requiring that rates be based on cost. Id. However, Staff interprets this order to set a cap on the rates for access charges, and that further reductions are possible within the Plan for these services; accordingly, Staff sees no reason for their removal. Ameritech further argues that any reductions in costs for services should be reflected in up-dated cost studies for these services. Although Ameritech does not explicitly make a conclusion based on this fact, the implication is that Ameritech will file such cost studies and offer reduced rates. Staff does not consider this outcome very likely, as Ameritech is not currently required to file updated cost studies and would not do so if it is not in its best interest.

c. Reclassified Services

Ameritech addresses the impact of competitive reclassification of services only slightly in this proceeding. This is for good reason. As the Plan currently stands, there

is an incentive for the Company to reclassify services prematurely at the expense of its customers. Staff has shown that competitive reclassification has deeply impacted the Plan and its effectiveness. See Staff Ex. 13.0 at 26-29; Staff Ex. 27.0 at 25-27.

The Commission designated ten issues to specifically be reviewed in this proceeding, as set forth in Appendix A of the Alt. Reg. Order. Issue 7 requires a listing of services reclassified during the existence of the Plan. In response to Issue 7, Ameritech witness Gebhardt provided a list of reclassified services. Ameritech Ex. 1.0 at 15-17, Sched. 3. However, this list lacks supporting information. Schedule 3 is merely a list, but it lacks information regarding the availability of competitive alternatives to the reclassified services. Further, Ameritech provides no numerical support to back its assertion that the impact of reclassification has been appropriate. Staff Ex. 13 at 14.

As noted in Staff's Initial Brief, the appropriateness of competitive reclassifications are at issue in ICC Docket No. 98-0860. Staff IB at 14. The outcome of this case will have significant impacts on the Plan. The most notable impact is in the Business Basket, which has been reduced to almost nothing. Revenues decreased from \$394,778,157 to \$22,856,154 between the 1997 and 1998 Annual Filings as a result of these reclassifications. Staff Exhibit 13.0 at 28. If the Commission rules that the services at issue in Docket No. 98-0860 must be returned to Ameritech's noncompetitive tariff, the Business Basket will be revitalized.

An improper classification of services can have significant consequences. GCI has proposed, and Staff endorses, penalties for improper competitive reclassification to remedy this problem. Ameritech views these penalties, up to \$10,000 per day, as "draconian". Ameritech IB at 51. Further, the Company argues that there is nothing in

the Public Utilities Act to permit penalties on improper classification. Id at 52. However, Staff is of the belief that these penalties are a completely appropriate means to thwart improper classification. The Commission has discretion on the exact amount it would choose to penalize the Company in case of improper classification, so using the term "draconian" to describe the penalty is a bit presumptuous. In modifying this Plan for the future, this proposal is a safeguard that helps transition services towards competition.

III. STAFF'S GOING FORWARD PROPOSAL

A. Proposal Relative to Existing Components

1. The Price Cap Formula

a. Inflation Factor

The current inflation factor used in the price cap formula is the fixed weighted gross domestic product price deflator (GDPPI). Staff, IB at 34; Ameritech, IB at 38; the State's Attorney General, IB at 49; Cook County, IB at 35; the City of Chicago, IB at 41; and the CUB IB at 55; all agree that it should be replaced by the chain weighted GDPPI. No other party has proposed a different inflation factor, and consequently the chain weighted GDPPI should be adopted by the Commission.

b. "X" Factor

Staff recommends a going forward "X" factor of 4.3% which consists of an industry productivity differential of 2.3%, an industry input price differential of 1% and a consumer dividend of 1%. Staff IB at 36. Ameritech proposes a going forward "X" factor of 3.3% which is based on an industry productivity differential of 2.3%, an

industry input price differential of 1% and no consumer dividend. Ameritech IB at 38-40. Cook County, IB at 33; the Citizens Utility Board, IB at 60; City of Chicago, IB at 41; and the State's Attorney General IB at 13 and 49; all argue for an "X" factor of 6.5% which is based on an FCC industry TFP study and includes a 0.5% consumer dividend. No other party has expressed views on the "X" factor.

Ameritech contends that the Commission should not extend the 1.0% consumer dividend in the current plan because it had the effect of flowing through the productivity gains that Ameritech Illinois achieved over the initial five-year period and an additional 0.8% that the Company did not achieve. Ameritech IB at 40. However, Staff demonstrated that on a company wide basis, Ameritech passed along less than half of the productivity gains it achieved over the initial five-year plan. Staff Ex. 2.0 at 17. Moreover, Ameritech passed along no productivity gains to consumers of its allegedly "competitive" services. Staff Ex. 16.0 at 16, 17. Prices of these services rose, while if the overall productivity gains achieved by Ameritech were passed on, the prices of these services should have fallen. Ameritech does not dispute this finding.

Ameritech's real argument is that the prices of non-competitive services fell by more than overall Company productivity gains would suggest they fell. Ameritech Ex. 1.3 at 81. This is true, but it did not prevent Ameritech from earning extremely good rates of return for the last five years. This is because, as previously stated, Ameritech was able to raise prices of so-called competitive services even though productivity gains dictate that these prices should have fallen. If, and only if, all services that are inappropriately classified as competitive are moved back to the non-competitive category, the Commission should then contemplate revising the consumer dividend.

Otherwise, eliminating the consumer dividend would only serve to increase Ameritech's already high earnings, while at the same time reduce the benefits consumers have derived from alternative regulation. Moreover, eliminating the consumer dividend does nothing to help consumers of so-called competitive services who would continue to pay much higher prices for these services than they should.

GCI argues that the "X" factor should be increased to 6.5% from the current 4.3%. GCI bases its "X" factor recommendation on the productivity offset used by the FCC for interstate services. However, Staff has demonstrated that the LEC productivity study used by the FCC to arrive at its 6.5% "X" factor is methodologically flawed, and, consequently, produces inaccurate output growth, input price growth and productivity growth estimates. Staff Ex. 16.0 at 10. The flaws include: (1) proxying local output by local calls only, when in fact local output consists of many services including lines and vertical services which grow at different rates than minutes, (2) excluding miscellaneous revenues from the output measure, and (3) inappropriately computing capital input prices based on realized rather than expected rates of return. Staff Ex. 16.0 at 10-16. GCI did not challenge Staff's criticisms of the FCC productivity study. Moreover, the FCC no longer characterizes its "X" factor as a productivity offset, instead it refers to the 6.5% as a policy instrument. Ameritech Ex. 2.2 at 19 (citing Sixth Report and Order ¶19).

GCI states that if the Commission does not adopt an offset of 6.5% then the Commission should retain the present consumer dividend of one percent (1%). Cook County IB at 33; City of Chicago IB at 41; AG IB at 53; CUB IB at 63. Staff agrees that

the present dividend should be retained. This leaves Ameritech as the only party that does not favor inclusion of a consumer dividend in the "X" factor.

In summary, the Commission should adopt an "X" factor of 4.3%. Ameritech's proposal to eliminate the consumer dividend and reduce the "X" factor to 3.3% would only serve to enrich the Company, which is already earning high rates of return, at the expense of subscribers. Finally, the Commission should reject GCI's recommended "X" factor of 6.5% which is based on a methodologically flawed productivity study and which greatly exceeds Ameritech's historical productivity growth of 3.5%. Ameritech Ex. at 7-9.

c. "Z" Factor

The Commission included the exogenous change, or "Z" factor, in the alternative regulation plan to permit Ameritech to recover costs over which it has no control. Staff does not propose any changes to the "Z" factor except to allow Ameritech the right to implement exogenous changes in a timely manner when the Commission orders rate cuts outside the plan that result in significant revenue decreases. Staff IB at 36-37. Ameritech shares the same view and argues that exogenous treatment in such circumstances is necessary to maintain the integrity of the "X" factor and as a matter of fairness to the Company. Ameritech, IB at 41; The City of Chicago, IB at 41; Cook County, IB at 46; the State Attorney General, IB at 62; and the Citizens Utility Board, IB at 64; do not propose any changes to the "Z" factor at all. CUB further argues that to allow automatic offsets for all Commission-mandated rate changes would circumvent the Commission's discretion to determine whether the price regulation formula is just and reasonable absent the offset. CUB IB at 64. Moreover, according to CUB it is

difficult to isolate the demand and revenue effects of Commission ordered rate changes and by implication argues it would therefore be difficult to determine what the appropriate size of the offsetting rate increases should be. CUB IB at 65.

It is understandable that the Commission should want some flexibility built into the price cap plan to deal with issues that cannot be satisfactorily dealt with elsewhere and the "Z" factor is a place where such discretion could be exercised. Staff Ex. 16 at 4. Nonetheless, it appears that GCI want to use the "Z" factor as a mechanism for managing earnings. If Ameritech's earnings are high, CUB argues that the Commission should mandate rate reductions and not allow Ameritech to recover the revenues lost from such a rate reduction. Staff Ex. 16 at 5. In this way, the Commission could move Ameritech's earnings to levels more acceptable to GCI. However, the Commission designed the "Z" factor to account for exogenous changes, not as a device to manage Ameritech's earnings under alternative regulation, and it is improper to use it as such. If the Commission truly seeks to manage Ameritech's earnings, it should order the company subjected to rate of return regulation.

Finally, it is immaterial whether it is complicated, or straightforward, to estimate revenue impacts from rate changes -- the question at hand is whether Ameritech should be permitted to recover revenue lost from Commission-mandated rate cuts through the exogenous factor. Staff Ex. 16.0 at 5. While it may be difficult to estimate revenue impacts from rate changes, the Commission can incorporate use of appropriate demand elasticities and take into account cost impacts when it allows "Z" factor treatment. Staff Ex. 16.0 at 5.

d. "Q" Factor

Staff recommends that the "Q" factor be eliminated from the price cap index, and instead, affected customers should, to the extent possible, be compensated for quality failures outside the cap through credits and rebates. Staff IB at 38. Ameritech believes that the current Plan has generally succeeded in maintaining service quality, and therefore recommends that only minor changes be made to the Plan's service quality penalty structure and that the "Q" factor remain in the price cap index. Ameritech IB at 84. The City of Chicago, IB at 42; Cook County, IB at 62; the State Attorney General, IB at 84; and the Citizens Utility Board, IB at 112; propose that the "Q" factor should be divorced from the price cap index and converted from a percentage of the index into a fixed dollar amount, and that customers affected by poor service quality be directly compensated as well.

The current "Q" factor has clearly not provided Ameritech with sufficient incentive to maintain service quality, especially in the areas of installation and repair. Moreover, customers who have been victimized by shabby service have not been compensated directly for the inconvenience they have suffered. Nonetheless, Ameritech proposes that the Commission maintain a system that has clearly proved inadequate. Keeping the "Q" factor in the price cap index will mean that customers who are affected by poor service are not directly compensated. Moreover, under the present system, it does not matter whether Ameritech misses a benchmark by an inch or a mile, the same penalty is assessed in either case. Staff believes a system of credits and rebates will furnish Ameritech the incentives it needs to maintain service quality.

2. Ameritech's Proposed Pricing Flexibility

a. Pricing Flexibility and Competition

In its Initial Brief, Ameritech Illinois argues that it should be permitted "significantly greater" pricing flexibility under the alternative regulation Plan. Ameritech IB at 6. Ameritech cites two reasons for such an increase: 1) it would allow Ameritech to adjust rates "to the more competitive marketplace", and 2) it would allow Ameritech to move toward a more "economically efficient rate structure." Ameritech IB at 6. Ameritech presents no compelling evidence to indicate that these protections should be "significantly" relaxed. In fact, Ameritech presents no compelling evidence that pricing flexibility should be increased at all.

Ameritech's concerns regarding increased competitive pressure rely on an analysis of the state of competition found in the direct testimony of Ameritech Witness Harris.⁴ Dr. Harris has filed substantial testimony on competition in this proceeding. City of Chicago Witness Selwyn notes that "Dr. Harris' largely anecdotal analysis of the competitive landscape, while impressive in scope, is light on substance." Staff notes that Ameritech relies on similar unquantified anecdotal analysis in its brief. See Ameritech IB at 25 and 26. As indicated throughout Staff Witness Dr. Zolnierrek's direct and rebuttal testimony, Staff concurs with Dr. Selwyn's analysis⁵. Dr. Zolnierrek has testified that, "...Dr. Harris has presented an incomplete picture of competition that in many cases, as outlined above, implicitly portrays more competition than, in fact, there

⁴ Dr. Harris' competition analysis is found in Ameritech Exhibit 4.0, and supporting schedules 2-4. Ameritech witness O'Brien notes "...Ameritech Illinois needs more pricing flexibility than was contained in the original Plan because competition has developed strongly during the Plan and is growing vigorously as described in Dr. Harris' direct and rebuttal testimony." See Ameritech Exhibit 3.1 at 10.

⁵ Staff Exhibit 3.0 and 17.0.

is.”⁶ Staff does not dispute that competition has increased since the inception of the alternative regulation plan. However, Ameritech has not demonstrated that competition has progressed faster than envisioned. The competitive information presented by Ameritech in this proceeding is incomplete and of little use. Consequently, it should not be used to justify a relaxation of competitive safeguards built into the current alternative regulation mechanism.

Ameritech concerns regarding the inefficiency of its rates rely primarily on the argument that its residential loop costs are too low and discourage efficient entry. Ameritech IB at 10. Ameritech argues that its residential loop rates do not reflect costs, in part, because of alleged improvements to its cost models, which have increased its loop costs relative to its network access line rates. Ameritech IB at 11 and 12. Clearly Ameritech’s assertions regarding the deficiencies of its past cost modeling and the significant changes it allegedly requires to correct these deficiencies, are not grounds on which to relax competitive safeguards built into the alternative regulation plan. Rather, such considerations are better addressed, as they are in this proceeding, and as suggested by Ameritech, within the context of an Ameritech proposal to rebalance rates. See Ameritech IB at 43.

b. Pricing Flexibility and Basket Structure

Ameritech alleges that neither GCI nor Staff have approached its pricing flexibility proposal in any “principled” way. Ameritech IB at 42. Ameritech also states that Staff’s and GCI’s concerns regarding basket consolidation are misplaced. Ameritech IB at 44.

In fact, Staff’s approach to pricing flexibility is highly principled, based upon the principles the General Assembly articulated with respect to alternative regulation plans

⁶ Staff Exhibit 3.0 at page 16.

and telecommunications generally. The most significant of these principles is the idea that rates shall be just, reasonable and affordable, and that customers shall be protected. 220 ILCS 13-102(a), 13-103(a), (b), (d); 13-506.1(a)(6), (b)(2). Staff's highly principled plan identifies several defects in Ameritech's proposal. *See, generally*, Staff Exhibit 13.0 and Staff Exhibit 27.0.

Initially, Ameritech proposed 15% pricing flexibility to go along with basket consolidation. Ameritech Ex. 3.0 at 16-18. Such flexibility would only provide the Company with the opportunity to increase rates for the least price elastic services and decrease rates for the most price elastic services. Staff Ex. 13 at 35. Providing the Company with a large amount of freedom to price its noncompetitive services gives it less of an incentive to open up its markets for competition and the ability to engage in predatory pricing. Staff Ex. 13.0 at 36.

Staff's arguments against Ameritech's initial pricing flexibility proposal appear not only to be principled but also persuasive. In fact, Ameritech altered its proposal for pricing flexibility in the Rebuttal Testimony of Ameritech Illinois witness Thomas O'Brien. AI Exhibit 3.1. The first alternative is that Ameritech will limit its upward pricing flexibility to 5% if its rate rebalancing proposal is accepted. Mr. O'Brien states that less upward pricing flexibility would be needed if the rebalancing proposal were accepted. Although this revised proposal seems to be a significant compromise, it would still give the company the ability to exercise Ramsey pricing. The Plan's current upward pricing flexibility is limited to 2% plus the percentage change in the PCI. Since the PCI has been decreasing by roughly 2% every year, there has been no upward pricing flexibility. Therefore, the revised AI proposal would allow significant rate increases for

noncompetitive services, which have not had any increases since the Plan's inception. Further, this reduction in the proposed pricing flexibility would require a large increase in residential rates through the rebalancing proposal. This proposal would still be very harmful to AI's most vulnerable customers⁷.

Ameritech's second alternative is advanced contingent upon the Commission declining to approve the company's rate rebalancing proposal. Under this alternative, the upward limit on pricing flexibility would be 10%, with a 30% limit over the next five years for any individual service. With this alternative, Mr. O'Brien is admitting that 10% pricing flexibility would allow AI to rebalance its noncompetitive services sufficiently. As with the first alternative, and the original proposal, consumers of AI's least competitive services would unquestionably be prejudiced.

In the context of the Plan, customer class discrimination occurs when a specific class does not receive the rate reductions given to other classes. To avoid such discrimination, the Commission placed residential, business, and carrier services in separate baskets. Therefore, when rate reductions are required in an annual filing, each customer class receives similar benefits. Any combining of service baskets eliminates the protection that certain customers currently receive. As Mr. O'Brien states, combining the baskets and allowing greater upward pricing flexibility will lead to rate increases for residential customers. If overall rate reductions continue to be required as they have

⁷ As the Hearing Examiner's Proposed Order in Docket No. 98-0860 and the evidence adduced in this docket demonstrates, Ameritech's treatment of captive customers has not been solicitous. The HEPO in Docket No. 98-0860 recommends the Commission find that Ameritech improperly reclassified services as competitive and improperly raised rates for many of them. Likewise, Ameritech's dismal record with regard to service quality is a matter of record in this proceeding. Accordingly, Ameritech cannot suggest that other parties are somehow behaving in an unprincipled manner by considering the needs of such customers. Indeed, Ameritech's past conduct and going forward proposal appear to be guided by no principle other than maximizing non-competitive revenues at the expense of captive customers, by raising their rates and providing them substandard service.

been in every annual filing to date, residential customers would not benefit at all. This is exactly what is meant by discrimination.

B. New Components

Staff does not propose any new components be added to the price cap formula. Staff IB at 47. Ameritech is also not recommending the inclusion of additional components to the Plan. Ameritech IB at 50. Cook County, IB at 39; the City of Chicago, IB at 41; the State Attorney General, IB at 63-65; and the Citizens Utility Board, IB at 83; want to add an "M" factor to pass through merger savings and many of the parties also want a \$10,000 fine imposed for services that were ruled to be improperly classified as competitive.

Staff would prefer that merger savings be handled through a one-time permanent adjustment to the PCI. Alternatively, the Commission could calculate an "M" factor based upon merger savings.

The fines for improperly classifying services are best handled the same way as credits are for poor service — outside the price cap. Fines should be treated as one-time events and not permanently embedded in the price cap index on a going forward basis.

C. Re-initialization of Rates

Staff is concerned that Ameritech's Initial Brief mischaracterizes (or may leave a misimpression of) Staff's position concerning the issue of rate "reinitialization". Rate reinitialization is defined in Ameritech's Initial Brief as reducing rates "... to the level that

would result from a traditional rate case, using rate of return principles". Ameritech IB at 53. Staff agrees with Ameritech that the Company's rates should not be reinitialized - as defined in this manner - in this proceeding. Specifically, Staff opposes "reinitialization" based on or due to Ameritech's earnings under the Plan, since Staff does not consider those earnings and associated rates, when properly evaluated, to be unfair, unjust or unreasonable. However, the term rate "reinitialization" (more generally and absent a designation to relate this specifically to earnings) can refer to any reduction that might occur to Ameritech's "ongoing" aggregate revenues, regardless of the reason. Reinitialization could occur for any number of reasons unrelated to Ameritech's earnings; for example, the Commission could determine that service quality deficiencies warrant a reduction in revenues. Staff has not proposed ongoing revenue adjustments (unrelated to earnings levels) in this proceeding, but does not oppose these in principle on economic or other grounds. Moreover, Staff consistently has recognized that the Commission may determine that aggregate revenue adjustments are warranted, based on Ameritech's earnings levels or based on other factors. Staff has recommended "one time" rate reductions in this proceeding for reasons unrelated to Ameritech earnings. Staff IB at 3.

Staff does not propose that Ameritech's rates be re-initialized, Staff IB at 47, nor does Ameritech, IB at 53. On the other hand the City of Chicago, IB at 38; the State Attorney General, IB at 66; Cook County, IB at 39; and CUB, IB at 84; believe rates should be re-initialized. The parties in favor of re-initialization argue that the high level of earnings achieved by Ameritech under the price cap plan indicate that the plan has failed in its goal to "protect the interests of all interested parties" and rates are therefore

not just and reasonable. CUB IB at 88. These parties go on to state that high returns show that for non-competitive services, the "X" factor has not fairly or sufficiently captured anticipated cost savings. AG IB at 69. Finally, without rate re-initialization, excessive levels of earnings will be "locked in." City of Chicago IB at 40.

Parties favoring re-initialization based on Ameritech's earnings levels judge the reasonableness of Ameritech's rates solely by the level of its earnings. Apparently they do not recognize that under alternative regulation non-competitive service subscribers receive a guarantee that their overall rates will rise less than general inflation while Ameritech gets the opportunity to earn higher returns. If Ameritech does indeed earn higher returns under alternative regulation this should not necessarily be interpreted as a failure of the plan but recognized as one of the possible outcomes that was anticipated. Staff Ex. 2.0 at 4. Contrary to what the State Attorney General claimed, the level of Ameritech's earnings under alternative regulation does not indicate that the current "X" factor has failed to capture anticipated cost savings. Ameritech's historical productivity gains are 3.5% per year, while the "X" factor is 4.3%. Ameritech Ex. 2.1 at 7-9. Ameritech has earned well under alternative regulation primarily because it has been able to classify services as competitive when effective competition did not in fact exist. Staff Ex. 2.0 at 5. As a result it has been able to raise prices for services that are not under the price cap. Staff Ex. 16.0 at 16,17. The solution that Staff consistently has recommended is to move the services in question back to the non-competitive category. The Commission should not order that existing non-competitive rates be reduced in price to bring Ameritech's earnings back to rate -of-return based levels. This would lower the price of these services to below what would exist in competitive

markets. Staff Ex. 16.0 at 16, 17. Rather, the Commission should reduce the prices of services that are moved back to the non-competitive category to what they would have been had they always been under the alternative regulation plan. Staff Ex. 2.0 at 5.

The March 30, 2001 HEPO in Docket No. 98-0860, if adopted by the Commission, would reduce prices in precisely this manner. Staff estimates that the resultant overall annual revenue reduction would be upwards of \$100 million. Staff further estimates that adoption of this HEPO would result in one time refunds to end users of approximately \$150 to \$200 million.

D. Earnings Sharing

Staff does not propose that an earnings sharing component be imposed on the alternative regulation plan. Staff IB at 49. Ameritech concurs. Ameritech IB at 58. In contrast, Cook County, IB at 42; the State's Attorney General, IB at 69; and the Citizens Utility Board, IB at 92; believe alternative regulation should incorporate an earnings sharing mechanism. The basic argument put forth by these parties is that earnings sharing would provide a degree of protection to customers against insufficient productivity offsets requiring Ameritech Illinois to share "excessive" earnings. CUB IB at 94. In addition, sharing can provide consumers some form of protection from improper exercise of monopoly power, poorly managed service performance, unforeseen economic conditions and improperly classified services. AG IB at 70.

Currently, under alternative regulation subscribers of non-competitive services are guaranteed that the prices they pay will rise at less than the rate of inflation. The productivity offset is based on historical productivity growth and includes a consumer

dividend. Consumers of non-competitive services therefore are already "protected". If Ameritech is inappropriately classifying services as competitive when effective competition does not exist and is increasing earnings by then raising prices, the solution is to move the services in question back to the non-competitive category. The answer is not to impose earnings sharing. Rather, the solution to this problem is to screen Ameritech's reclassifications more stringently.

Earnings sharing represents double regulation. Staff Ex. 16 at 2. Adding an earnings sharing component to price cap regulation would mean that both prices and earnings of Ameritech would be regulated. Moreover, earnings sharing would bring with it all the problems associated with rate of return regulation. In addition, earnings sharing is impossible to implement in any meaningful fashion when some services are subject to competition while others are not. Imposing earnings sharing on the entire company would mean that subscribers of non-competitive services would inappropriately share the risks and rewards of Ameritech's management decisions in the competitive arena. Staff Ex. 16 at 2-3. Alternatively, the Commission could split common costs between competitive and non-competitive services and impose earnings sharing only on non-competitive services. However, this cannot be accomplished in any rational way, because common and fixed costs cannot satisfactorily be allocated between competitive and non-competitive services by definition. Staff Ex. 16 at 2.

E. Rate of Return

Staff believes that alternative regulation should be modified to yield results consistent with statutory requirements and the Commission policy goals and objectives.

Staff IB at 50. It views rate of return as a second and inferior alternative. Id. Not surprisingly, Ameritech does not favor a return to rate of return. Ameritech IB at 61. Cook County, IB at 42; the Citizens Utility Board, IB at 98; and the State Attorney General, IB at 71; also believe that alternative regulation should be modified to meet statutory requirements and if can't be, then rate of return regulation should be re-instated. The City of Chicago, IB at 40, has strong reservations whether alternative regulation under any terms is in the public interest. Consequently, it favors return to rate of return regulation.

The vast majority of parties therefore believe that alternative regulation should continue but in a modified form. The parties differ widely on how alternative regulation should be reformed. Nevertheless, only the City of Chicago wants rate of return re-instated under any circumstances. Rate of return is regulatory mechanism not well-suited to facilitate the transition from monopoly to competition and consequently is inappropriate for current market conditions in the telecommunications industry. Staff IB at 51.

F. Reporting Requirements

Staff's position regarding monitoring and reporting requirements is discussed fully at pages 19-22 of its Initial Brief. However, Staff objects to Ameritech's mischaracterization of the record in its Initial Brief. Ameritech alleges that no party has objected to its filing of the same annual infrastructure investment report as is required by the Merger Order. Ameritech IB at 48. Staff's testimony clearly requests that the infrastructure investment report be provided by project. Staff Ex. 4.0 at 13-15.

Ameritech also alleges that Staff provided no compelling rationale for requiring earnings-related reporting (items 1-6 in Appendix B of Ameritech's Initial Brief). Ameritech IB at 48. Staff's rationale is fully described in its testimony. See Staff Ex. 4.0 at 17. Finally, Ameritech alleges that no party has objected to its proposal to eliminate filing requirements 8-11 and 13-14 in Appendix B which summarize information included in Ameritech's annual price cap filing. Ameritech is fully aware of Staff's position that every requirement or condition of the Alt. Reg. Plan should be available from a single source, the required report. Staff Ex. 4.0 at 10 and 17.

G. Merger Costs and Savings

In its September 23, 1999 Order in Docket 98-0555 this Commission approved the merger of Ameritech Corporation and Southwestern Bell Corporation ("SBC"). In that docket Merger Condition 26 states that one-half (50%) of net actual merger savings must be allocated to Ameritech's customers. Order Docket No. 98-0555 at 243 (hereafter "Merger Order"). Actual net merger savings are tracked on a calendar year basis and reported in Ameritech's annual price cap filing. Staff Ex. 4.0 at 8. The Commission also required that an independent third-party auditor be retained to review the methodology and standards for tracking merger savings, as well as audit the amount of net merger savings on an annual basis. Merger Order at 149. This condition of the merger is scheduled to terminate with the Commission's final order in the instant proceeding. *Id.* at 146.

In accordance with the Merger Order, the Barrington Wellesley Group, Inc. ("BWG") was retained by the Commission to perform these functions. Staff Ex. 4.0 at

8. BWG's final report on this project was presented to the Commission on January 30, 2001. Id. The timing of this report did not allow the parties to address it within the schedule of this docket. Id. Another docket (01-0128) was initiated by the Commission to allow the parties to present evidence addressing BWG's Final Report. Initiating Order, Docket 01-0128, (released Feb.7, 2001).

Ameritech Illinois proposed that the terms of the Merger Order continue to be applied during the period from October 1999 through December 31, 2002. Ameritech Ex. 3.0 at 29-34. Ameritech proposes that the net merger savings for the year 2002 be considered the permanent, going-forward level for merger related savings, resulting in a permanent one-time adjustment to the price cap index ("PCI"). Id.

The period recommended by Ameritech is not sufficient to capture all merger related costs and savings at a going-forward level. Staff Ex. 18 at 9-10. Much of the delay associated with BWG's audit was due to the unavailability of actual audited data on an expedited basis and to the time required by SBC to implement a system for tracking merger costs and savings. Id. Therefore, Staff witness Marshall recommended that the terms of the merger condition remain in effect until the Commission completes its next review of the alternative regulation plan. Id. It is Staff's position that the plan adopted by the Commission in this docket will be reviewed in approximately four years, with a final order in place prior to July 1st of the fifth year. It is not necessary for the Commission to pre-judge what should occur at the end of the five year period. Id.

Based on the Merger Order, Staff recommends that any alternative regulatory plan approved in this proceeding be reviewed in five years – when the majority of

savings will be truly reflected.. Merger Order, at 146 (stating that the net merger savings is to be allocated to consumers using an interim methodology until "the appropriate mechanisms are made in the five-year review of the Plan.") If the Commission does not order such a review of the plan, a decision is needed on the future treatment of merger costs and savings. Staff Ex. 18.0 at 8.

Additionally, Staff does not agree with Ameritech that the amount of net merger savings should be based upon the year 2002 results because the actual merger-related savings will not be determined at that time. Current SBC projections indicate that the going level of merger related costs and savings will not be reached until 2004. Id. at 8-9. Approximately 96% of the going level will have been reached at the end of 2002, if implementation of best practices identified by SBC's merger integration teams is achieved on schedule. See id. (citing BWG Final Report at VIII-27). Significant savings are projected in the areas of procurement and benefits and these savings are less likely to be fully reflected in 2002 actual amounts because of delays in implementation of planned best practices. Id. One of BWG's recommendations is that the Commission consider extending the three-year period for sharing of net merger savings to ensure an equitable apportionment to the Company and its ratepayers. See id. at 9 (citing BWG Final Report at VIII-44).

Staff agrees with Ameritech witness O'Brien's statement that merger related costs and savings could be passed along to customers outside of the annual filing. Id. It is appropriate that merger related costs and savings should be passed to customers as soon as they have been identified by the Commission. This treatment would parallel the company's proposed treatment of exogenous factors. Id.

If the Commission does not order a future review of the alternative regulation plan in this docket, Staff recommends that the Commission continue the annual audits of merger related costs and savings until SBC/Ameritech achieves a going level of net savings. Merger Order at 146 (stating "this information will continue to be provided in Ameritech's annual price cap filings . . ."). As stated above, this going level of savings will not be reached before 2004. Audited information for 2004 will be available in 2005. The audited 2004 data could also be compared to actual 2005 data for reasonableness. Effective with the price cap filing of April 1, 2006, the Commission could make a one-time adjustment to the price cap index to reflect the going level of merger costs and savings and discontinue the annual audit requirement. The final year of audited merger costs and savings would be 2004, which is equivalent to the time frame associated with continuing this requirement until a five year review of the alternative regulatory plan. Staff Ex. 18.0 at 9-10.

As an alternative, the Commission could consider modifying its requirement that actual merger costs and savings be audited annually. If such a modification were adopted, the Commission could adjust the alternative regulatory formula at this time to reflect 50% of SBC's current estimate of merger costs and savings at the going level. Merger costs and savings amounts have already been reviewed by SBC's upper management levels and thoroughly analyzed by SBC's merger integration teams. Id. at 10. Therefore, the current estimate of net merger related costs and savings of ~~\$XX~~ billion has a high probability of being achieved. Id. As noted at page VIII-21 of BWG's final report, "The transition Policy Group ("TPG") made clear to the teams that targets

were firm and not negotiable. Id. The only exception was that benchmarking errors could be corrected, but only if it made a difference." Id.

Staff believes that adoption of a merger costs and savings factor at this time would reduce the regulatory burden of determining the actual amount of costs and savings on an annual basis. It would conserve both Commission and Company resources expended in the annual audits and would simplify the annual price cap filing proceedings. Condition 26 of the Merger Order requires annual audits of actual merger costs and savings, and will expire if the Commission chooses a different approach to merger costs and savings in this docket. Merger Order, at 146.

Although requested in Staff rebuttal testimony, Ameritech did not provide an allocation of the revised amount of planned net merger costs and savings to Illinois Intrastate operations for use in this case. However, such an allocation was provided by Ameritech in the merger case, Docket 98-0555. A parallel calculation can be made based upon the evidence provided by Staff. Staff Ex. 18.0 at 11.

Since the planned net merger savings have increased by approximately ~~XX%~~, Staff anticipates a comparable increase in the Illinois jurisdictional going level amount previously calculated to be \$90 million. Id. The Commission has ordered that 50% of net merger savings be shared with ratepayers. Id. Increasing the \$90 million by ~~XX%~~ and allocating 50% of this amount to ratepayers results in an Illinois jurisdictional annual going level of ~~\$XX~~ million. The Commission may elect to either make a one-time permanent adjustment to the PCI to reflect this ~~\$XX~~ million or it may calculate an M factor based upon ~~\$XX~~ million. Inclusion of an M factor in the price cap formula has the advantage of allowing future adjustments related to mergers.